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SUBJECT: RUSSIAN ENERGY: RUSSIANS RETHINK SHTOKMAN

Classified By: Amb. William J. Burns. Reasons 1.4 (b/d).

11. (C) Summary. Gazprom's October 8 decision to reject foreign equity participation in the giant Shtokman gas and LNG project in the Barents Sea, in favor of developing the field itself, reflects a growing trend towards energy nationalism, and genuine concern about maintaining control of such a key gas flow. Putin's impending trip to Germany may have been a factor in the announcements timing. Our companies and the others on the "short list" are taking a low-key approach to the news, probably in part because Gazprom insists it will use foreign firms for Shtokman as contractors.

12. (C) Gazprom's decision to flip-flop the priority destination for Shtokman gas from North America to Europe in the first phase of development does not mark the abandonment of the North American market. Most analysts believe these moves reflect a growing acknowledgement of the gas supply problem beginning to plague Gazprom's foreign (and domestic) commitments. Amplifying this was Gazprom's decision on October 6 to develop the supergiant Bovanenko field on the Yamal peninsula that promises faster gas flows and quicker payback. WTO undertones were markedly absent from the official rhetoric surrounding these recent announcements. End Summary.

13. (C) In a statement posted on the Gazprom website, Gazprom CEO Alexey Miller indicated that the company would not bring on foreign companies as partners in developing the giant Shtokman field but would instead maintain complete control of the project and contract out the work to willing firms. Miller explained this move as resulting from the failure of the foreign bidders to offer assets and activities for trade that "correspond to the volume and quality of Shtokman reserves." The statement goes on to say that Gazprom will send the field's gas through the North European Gas Pipeline (NEGP) as a priority over Liquefied Natural Gas (LNG) supplies to North America.

14. (C) We canvassed the companies on the so-called "short list". ConocoPhillips told us they had only discovered the news on television the night before and as of October 9 still had received nothing official from Gazprom and as such had not developed an official position. Chevron said the same, except that they have drafted some official talking points welcoming whatever form of cooperation with Shtokman (and implicitly other projects) Gazprom may deem appropriate. The

Norwegian embassy told us that their companies (Norsk Hydro and Statoil) are "disappointed and frustrated" but are keeping a low profile until the situation is clearer. Their companies doubt Gazprom is capable of developing the field efficiently alone and the embassy adds that the decision heightens concerns the Norwegian government has about responsible stewardship of the Barents Sea environment. According to Vladimir Konovalov, head of the Petroleum Advisory Forum (PAF), the companies he has spoken with seemed to have been caught flat-footed and are still in assessment mode.

15. (C) Other actors in the Shtokman drama had similar/differing observations and analyses.

-- Gazprom itself told us officially on October 9 two points that differ from the tone of the press coverage (but are consistent with their website's words). First, there "absolutely" will be a role for foreign firms, just not the equity stake previously considered -- they will now be "contractors". (By implication, this may well mean U.S. and other foreign companies not on the longstanding "short list.") Second, Gazprom stressed that the marketing strategy for Shtokman gas will not change at all -- some will go to North America and some to Europe, as was always envisioned.

-- Konovalov's (PAF) sources in the government told him that the giant cost overruns on Shell's Sakhalin-2 project gave Gazprom a glimpse at how costly and lengthy the Shtokman project might be. He continued that Russia's walk-back on the project may be an indication that, rather than Shtokman, the company may develop fields in Yamal and/or in West Siberia, which Konovalov contends would be cheaper and quicker. In fact, Gazprom's board on October 6 decided to invest heavily in the supergiant Bovanenko gas field on the

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Yamal Peninsula that Gazprom calculates could be the major new source of pipeline gas to Europe.

WHY NOW? -- FOUR POTENTIAL EXPLANATIONS

16. (C) It is fashionable to attribute any Shtokman decision to Russia's WTO ambitions. Gazprom has said nothing officially about a WTO linkage, although obviously the Kremlin has in the past calculated the two in tandem. If this announcement were truly linked to WTO accession as many observers surmise, then the GOR would likely have waited until November before making an announcement on Shtokman, given the schedule of current talks underway on WTO. The optics of a November Shtokman decision would work better for the Russians by allowing them to publicly hang this on an inability to come to terms with the USG on the trade deal.

17. (C) If the WTO is a red-herring, or at least only one of several factors, what else explains these actions? First, senior Gazprom officials are beginning to believe (perhaps mistakenly) that they have the technical wherewithal to run the project themselves. The energy community in Moscow has heard this from well-placed sources and the evidence now seems self-explanatory. Learning by doing through LNG swaps into the U.S., UK, and Japanese markets, they may now believe they have the requisite "smarts." A solid year of learning inside baseball from five of the world's best companies probably amplified a self-confidence already brimming from high prices and sudden stature on world stock markets. Financial analysts in Moscow nonetheless roundly criticized the announcement for the reasons that Gazprom is neither technologically capable of solo development of Shtokman and that Gazprom has foregone the chance to share financial risk on what will be one of history's most expensive projects.

18. (C) Second -- and the most convincing reason to us -- recently our contacts have been telling us that Gazprom officials are beginning to accept that the firm may face a

looming gas production crunch just as many (including the IEA) have been predicting. If this "lightbulb" has gone on at Gazprom, then the decision to switch priorities from LNG to piped gas to Europe makes some sense. Gazprom has long-term commitments and relationships there and, as Miller said in the statement, the go-it-alone approach and the prioritization of supplies to Europe are "an additional guarantee of the long-term supply of Russian gas to Europe and proof that the European market is the most important to the company." Piping Shtokman gas to Europe had always been on the original plan. In fact, even after Putin (in Paris) hinted at sending more Shtokman gas to Europe by pipe, our companies here took it in stride with one company rep telling the Ambassador recently that they were "not concerned about the comments in Paris because they are consistent with longstanding plans."

¶9. (C) Third, Gazprom's Miller has long been used to "advance" Putin's meetings with foreign leaders. The fact that Putin is meeting Chancellor Merkel soon and that German firms (E.ON and Wintershall) have significant stakes in the NEGP lends credence to the idea that this announcement may partly be a trial balloon to gauge foreign reaction as well as to smooth the backdrop for Putin's trip to Germany. On the other hand, vast conspiracy theories such as that published in Kommersant's October 9 article about a major turn away from the U.S. and the Comecon-like integration of Germany into Russia's energy infrastructure strike most here as imaginatively far-fetched.

¶10. (C) Some instant reactions we have heard also attribute the announcements to the strong drift in Russian energy to move away from foreign participation in big projects. Although Gazprom is willing to work with the foreign firms as contractors, such "resource nationalism" is probably reinforced by the commercial calculation that foreigners should not have a complicating say over the disposition of Russian gas.

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COMMENT

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¶11. (C) These reasons all coincide and amplify one another. While the announcements are a blow to our companies'

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prospects, the project's daunting technological and financial challenges coupled with the uncertain Russian environment cushions the blow. Either way we do neither ourselves nor our companies any favors by jumping into the fray with the Russians, who would likely relish an opportunity to justify their own decision to politicize Shtokman via a WTO linkage. With the decisions made, the big operational questions are whether Gazprom really has learned as much as it thinks it has and, if not, how much of a delay this will entail. The "diversion" of supplies to Europe directly impacts us, but even that hardly merits more than consistent reminders to the Russians that we welcome their LNG and are pleased that they are learning how the overseas LNG market works and keeping their options to North America open. Our most recommendation is to maintain a professional tone in the interest of securing a position in whatever form for our companies in Shtokman and other LNG projects.
BURNS